Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:4:LOU:POSTF-144225-02
MDEblen

date: October 23, 2002

to: Examination-Compliance
Attn: L. Pat Mudd, Group 1404, Lexington, KY

from: Associate Area Counsel (SB/SE)
Louisville, Kentucky

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subject: **Advisory Opinion /** [redacted]

This responds to your request for an advisory opinion concerning the possibility of a double deduction for bonuses paid by an accrual method Personal Service Corporation (the "PSC"), which bonuses were incorrectly deducted as accrued rather than as paid on the PSC's fiscal year-end tax return, and the required accounting method change.

ISSUES

1. Does § 481 apply to [redacted]'s situation that an adjustment is required to convert [redacted] to the cash method of accounting for bonus payments made to the employee-owners? If § 481 does require an adjustment, may [redacted] spread the adjustment over more than one year?

2. Does the Third Circuit case Tate & Lyle v. Commissioner, 87 F.3d 99 (3d Cir. 1996) provide support for a double deduction for expenses accrued and deducted by a taxpayer for payments made to a related party as defined in § 267, when the taxpayer is required to change to the cash method of accounting for these payments?

CONCLUSIONS

1. Section 481 applies to [redacted] because it has been using an impermissible accounting method and will be required to change its accounting method with an adjustment for the bonuses accrued and deducted in [redacted] but not actually paid until [redacted]. The adjustment is required to prevent duplication of the bonus deduction. The change would be considered "involuntary" because the IRS is requiring [redacted] to change its method of accounting as the result of an examination of its return. Therefore, [redacted] is required to take the entire § 481(a) adjustment in the year of change, [redacted]. The

IRS may also impose penalties if it determines that [redacted]'s use of the accrual method constitutes negligence or that [redacted] substantially understated its tax liability due to using the accrual method, and there is no substantial authority supporting the method used. This conclusion was confirmed with Michael Burkom, Internal Revenue Agent in the Office of Chief Counsel, IRS National Office, Washington, D.C.

2. No. Double deductions for amounts adjusted as the result of an accounting method change are prohibited by I.R.C. § 481. The § 481 calculation purportedly giving Tate & Lyle a double deduction for the interest expense accrued and deducted in 1984 must be a mistake. The § 481(a) adjustment in Tate & Lyle was not part of the court's holding, and therefore has no precedential value, and [redacted] should not rely on it as a basis for its § 481(a) adjustment. This conclusion was also confirmed with Michael Burkom, Internal Revenue Agent in the Office of Chief Counsel, IRS National Office, Washington, D.C.

FACTS

[redacted] is and has always been a Personal Service Corporation ("PSC"), is on the accrual method of accounting, and its employee-owners are cash method taxpayers. No one shareholder, other than an ESOP trust, owns 50% or more of [redacted]'s shares. Since the 1970's, [redacted] has accrued and deducted bonuses in its fiscal year-end of August 31, but has consistently paid those bonuses the following December. The amounts accrued and deducted were $[redacted], $[redacted], $[redacted] and $[redacted] for the fiscal years ended August 31, [redacted], [redacted], [redacted] and [redacted], respectively. All of the bonuses were paid to employee-owners, who reported the bonuses on their tax returns for calendar years ended [redacted], [redacted], [redacted], and [redacted]. [redacted] is under audit for [redacted], [redacted] and [redacted].

In a prior advisory opinion, IRS Counsel concluded that [redacted] was using an impermissible method of accounting by deducting the bonuses on its tax return for the taxable years ended August 31, but not paying the bonuses until the following December. Sections 267 and 269A provide that a payment by an accrual method PSC to any employee-owner may only be deducted "as of the day" as of which the amount is includible in the gross income of the employee-owner. Because the bonuses were paid in December following [redacted]'s fiscal year end of August 31, [redacted] should not be allowed a deduction for the bonuses until its tax year that includes the day the bonuses are paid. [redacted] should be required to change to the cash method of accounting for bonus payments made to employee-owners.

[redacted] has asserted that Tate & Lyle, Inc. v. Commissioner, 87 F.3d 99 (3d Cir. 1996) provides authority for a taxpayer to take a double deduction for payments made to a related party when the taxpayer is required to change its method of accounting to deduct the payments only when made.

ANALYSIS

1. Accounting Method Change

Generally, a taxpayer may not change its accounting method without first obtaining the consent of the IRS. General procedures for obtaining this consent are spelled out in Rev. Proc. 97-27, 1997-1 C.B. 680. If a taxpayer is using an improper method of accounting, the IRS has the authority to change a taxpayer's method of accounting to a method that, in the opinion of the Commissioner, clearly reflects income. I.R.C. § 446(b).

Duplicated or omitted items of income and expense are referred to as "adjustments" and include accounts receivable, accounts payable, inventories, and other items. Treas. Reg. § 1.481-1(b). "Other items" include deferred expenses. The adjustment includes all affected items as of the beginning of the year of change. Treas. Reg. § 1.481-1(c)(1). The adjustment also includes amounts that would otherwise be barred by the statute of limitations. See Graff Chevrolet Co. v. Campbell, 343 F.2d 568 (5th Cir. 1965). This adjustment is taken into account in order to prevent duplication or omission of income or deduction items that would occur solely because of the change of accounting method. I.R.C. § 481(a).

"In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted." Treas. Reg. § 1.481-1(a)(1). "The adjustments specified in section 481(a) and this section shall take into account ... any other item determined to be necessary in order to prevent amounts from being duplicated or omitted." Treas. Reg. § 1.481-1(b).

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used. Rev. Proc. 2002-9, I.R.B. 2002-3, 327, § 2.05(1).

Tax Year in Which the Adjustment is Made

The IRS normally requests that an accounting method change be made in the earliest year under audit when it discovers an erroneous accounting method that understates income and requires that the taxpayer take the § 481(a) adjustment computed as of the beginning of the year of change into account entirely in the year of change. Id. The spread of a § 481(a) adjustment generally occurs only in voluntary method changes and results from an exercise of discretion by the IRS under Treas. Reg. § 1.446-1(e)(3). See also Treas. Reg. § 1.481-4(b).

A change in method is considered "involuntary" by the IRS if it is required as a result of an examination of the taxpayer's return. Treas. Reg. § 1.481-1(c). Most involuntary changes involve methods that understate income. The IRS may also impose penalties if (1) the taxpayer's use of the improper method constitutes negligence; or (2) the taxpayer substantially understates its tax liability due to the taxpayer's chosen method of accounting, and there is no substantial authority supporting the method used. I.R.C. § 6662.

In Rev. Proc. 2002-18, 2002-13 I.R.B. 678, § 1.02, the IRS states that when it uses the involuntary change procedures, the taxpayer "generally receives less favorable terms and conditions" than if the taxpayer had used the voluntary change procedures before being contacted for examination. The IRS has advised that since the examining agent initiated the change in method of accounting, the entire amount of the adjustment must be taken into account in the year of change. Tech. Adv. Mem. 9649006 (Aug. 22, 1996); Tech. Adv. Mem. 9640003 (Dec. 21, 1995). See also FSA 200003038. Additionally, the Tax Court has noted that "changes required under examination are applied by default to the earliest year for which the limitations period has not expired." Buyers Home Warranty Co. v. Commissioner, T.C. Memo. 1998-98.

A savings and loan association that was required by the IRS to change its method of accounting for interest from mortgage pass-through certificates was not entitled to spread the resulting adjustment over more than one tax year. The savings and loan had not received the IRS's agreement or approval to extend the period for taking the adjustment into account, and the IRS did not abuse its discretion in refusing to grant permission for the extended adjustment period. Capitol Fed. Sav. & Loan Ass'n v. Commissioner, 96 T.C. 204 (1991).

The Taxpayer must be given Notice of the Accounting Method Change

The IRS must notify a taxpayer that his accounting method has been changed. Rev. Proc. 2002-18, 2002-13 I.R.B. 678, § 5.01(1). The revenue procedure requires an examining agent, an appeals officer, or counsel for the government to notify the taxpayer in writing that it is treating the change as a change in accounting method. The notice must: (1) state that the timing issue is being treated as an accounting method change or clearly label the adjustment as a § 481(a) adjustment, and (2) describe the new accounting method. Without the required notice, a taxpayer's accounting method would not be changed. Rev. Proc. 2002-18, 2002-13 I.R.B. 678, § 5.01(4).

Application to [redacted]

As we concluded in the prior advisory opinion, [redacted] has been using an impermissible accounting method since the [redacted]'s to deduct bonuses paid to employee-owners. [redacted] has accrued and deducted bonuses in its fiscal year-end of August 31, but has consistently paid those bonuses the following December. The amounts accrued and deducted were $[redacted], $[redacted], $[redacted] and $[redacted] for the fiscal years ended [redacted], [redacted], [redacted], and [redacted], respectively.

[redacted]'s § 481(a) adjustment and affect on taxable income should be as follows:

	[redacted]	[redacted]	[redacted]	[redacted]
Bonus Expense Per Tax Returns				
Accrued	$[redacted]	$[redacted]	$[redacted]	$[redacted]
Bonuses Paid		[redacted]	[redacted]	[redacted]
§ 481(a) adjustment Affect on Tax returns				
Increase to Income				
§ 481(a) adjustment		$[redacted]	$[redacted]	$[redacted]
Disallowance of bonuses accrued not paid		[redacted]	[redacted]	[redacted]
Total Increase to Income		[redacted]	[redacted]	[redacted]
Less: deduction for bonuses paid		[redacted]	[redacted]	[redacted]
Net Increase (decrease) to income		$[redacted]	$[redacted]	$[redacted]

The above calculation was confirmed with Michael Burkom, Internal Revenue Agent in the Office of Chief Counsel, IRS National Office, Washington, D.C.

[redacted]'s change in accounting method is considered "involuntary" because the IRS is requiring the change as the result of an examination of [redacted]'s return. Pursuant to the technical advice memorandums cited above, [redacted] must take the entire § 481(a) adjustment in the year of change, [redacted]. The IRS may also impose

penalties if it determines that [redacted]s use of the accrual method constitutes negligence or that [redacted] substantially understated its tax liability due to using the accrual method, and there is no substantial authority supporting the method used. I.R.C. § 6662.

[redacted] got the full benefit of the $[redacted] bonus expense accrued and deducted in [redacted]. Section 481 requires that this amount be the § 481(a) adjustment in the year of the accounting method change to prevent duplication of this deduction. As discussed above, the accounting method change requires that income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting. Rev. Proc. 2002-9 § 2.05(1).

Because [redacted] is the year of the accounting method change, [redacted] will deduct the $[redacted] bonus expense again in [redacted] the year the amount was actually paid. [redacted] will also include the entire amount of the § 481(a) adjustment, $[redacted] in its income for [redacted], in addition to including the amount that was accrued and deducted in [redacted] that was not actually paid in that year, $[redacted]. As discussed above, the amount accrued and deducted in [redacted], the year prior to the accounting method change year, is included in the § 481(a) adjustment even though that year would otherwise be barred by the statute of limitations. Graff Chevrolet Co. v. Campbell, 343 F.2d 568 (5th Cir. 1965). This conclusion was confirmed with Michael Burkom, Internal Revenue Agent in the Office of Chief Counsel, IRS National Office, Washington, D.C.

2. Tate & Lyle v. Commissioner - No Double Deduction Permitted

In Tate & Lyle, Inc. v. Commissioner, 103 T.C. 656 (1994), the Tax Court held that Treas. Reg. § 1.267(a)-3 is invalid to the extent that it requires accrual basis taxpayers to defer deductions for interest owed to a related foreign payee until the year the interest is paid. The Third Circuit reversed the Tax Court, finding that Treas. Reg. § 1.267(a)-3 is a valid exercise of the powers delegated to the Treasury Secretary under § 267(a)(3). Tate & Lyle, Inc. v. Commissioner, 87 F.3d 99 (3d Cir. 1996). Based on this reversal, the court upheld the Commissioner's determination of the taxpayer's deficiency based on the taxpayer accruing and deducting interest payments to a related party in a year prior to the year in which the payments were actually made.

[redacted] has asserted that the IRS's calculation of the taxpayer's deficiency in Tate & Lyle provides authority for a taxpayer to get a double deduction for payments made to a related party. Specifically, [redacted] asserts that when a taxpayer is required to change from the accrual method to the cash method of accounting for

payments to a related party, as defined in § 267, a taxpayer may deduct the payment made in the year before the change, the year in which it was accrued and deducted, and also deduct that same payment in the year of the accounting method change, when the amount is actually paid. Although it appears that the IRS's calculation of Tate & Lyle's liability, as shown in footnote 7 of the court's opinion, gives the taxpayer a double deduction, a double benefit would not be allowed by § 481. The footnote is as follows:

> In computing the adjustment to taxable income in the notices of deficiency, the Commissioner offset the disallowed accrued but unpaid interest in each year by the amount of the interest actually paid in each year, resulting in the following net interest adjustments:
>
> | | 9/30/84 | 9/29/85 | 9/28/86 | 9/26/87 |
> |---|---|---|---|---|
> | Interest Accrued | $185,152 | $ 204,397 | $ 601,883 | $ 681,459 |
> | Interest Paid | | (185,152) | (204,397) | (601,883) |
> | Notice of Deficiency Adjustment | | $ 19,245 | $ 397,486 | $ 79,576 |
>
> The tax year ended September 30, 1984 is not at issue in this case.

In the tax year ended September 29, 1985, the deficiency for that year was calculated by reducing the amount accrued by the amount actually paid to arrive at the disallowed deduction. The same calculation was made for the subsequent two tax years to determine the company's total deficiency. Although it appears that the IRS gave Tate & Lyle a double benefit for the amount accrued in 1984 and deducted in 1985, this should not have been the case. Even though 1984 was not at issue, the amount accrued and deducted in that year should have been the § 481(a) adjustment and added back to income in 1985. Netting the amount paid in 1984 with the § 481(a) adjustment of the same amount, and adding the amount accrued but not paid results in an increase to Tate & Lyle's income for 1985 of $204,397. As discussed above, § 481 prohibits taxpayers from obtaining a double deduction for one expense. Therefore, the portion of the § 481 calculation giving Tate & Lyle a double deduction for the interest expense accrued and deducted in 1984 must have been a mistake.

Tate & Lyle involved two issues, neither of which was the calculation of the § 481 adjustment. Neither the Tax Court nor the Third Circuit Court of Appeals discusses the IRS's § 481 calculation, which is included in the facts of the Tax Court case, and only in a footnote to the Third Circuit's opinion. Even though the § 481(a) calculation is displayed in the cases, it appears there

only to show the IRS's calculation, not as part of either court's opinion. Therefore, because the § 481(a) calculation in Tate & Lyle was not part of the court's holding, it should have no precedential value, and taxpayers should not rely on it as the correct method of calculating a § 481(a) adjustment.

Application to [redacted]

Double deductions for amounts adjusted as the result of an accounting method change are prohibited by I.R.C. § 481. As stated above, the § 481 calculation giving Tate & Lyle a double deduction for the interest expense accrued and deducted in 1984 must be a mistake. [redacted] should not rely on the IRS's calculation of another entity's § 481(a) adjustment as a basis for its § 481(a) adjustment. The adjustment in Tate & Lyle was not part of the court's holding, and therefore has no precedential value.

[redacted] should not be allowed to deduct again in [redacted] the bonuses it accrued and deducted in [redacted]. Allowing it to do so would be to allow a double deduction prohibited by § 481. This conclusion was confirmed with Michael Burkom, Internal Revenue Agent in the Office of Chief Counsel, IRS National Office, Washington, D.C.

We appreciate the opportunity to provide our views concerning the deductibility of bonuses paid by a Personal Service Corporation after its fiscal year-end. With this memorandum, we are closing our file. We hope you will take a moment to complete the enclosed "Counsel's Client Satisfaction Survey" regarding our assistance with this case. We intend to use your valued feedback to improve the quality and timeliness of guidance provided to you, both in future advisory opinions and otherwise. If you have any questions or require additional assistance, please call the undersigned at telephone number (502) 582-6578.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

MARK D. EBLEN
Senior Attorney (SBSE)